DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0766
Corporate Adjusted Gross Income Tax—Combined Filing
Corporate Gross Income Tax—Sale/Leaseback
For Tax Year 1995-1996

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ISSUES

I. Corporate Adjusted Gross Income Tax—Combined Filing

Authority: **IC § 6-3-2-2** **45 IAC 3.1-1-62**
IC § 6-3-3-3
IC § 6-8.1-1-1
IC § 6-8.1-5-1(b)

Mobil Oil Corporation v. Commissioner of Taxes of Vermont, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin,* 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico,* 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 112 S. Ct. 2251 (1992).

Taxpayer protests the Department's finding that taxpayer may not file a combined return for the tax year at issue.

II. Corporate Gross Income Tax—Sale/Leaseback or Sales of Tangible Personal Property

Authority: **IC § 6-2.1-1-2(a)(3)** **45 IAC 1-1-29**
IC § 6-2.1-2-2
IC § 6-2.1-2-3
IC § 6-2.1-2-4
IC § 6-2.1-2-5

Taxpayer protests the assessment of Indiana gross income tax on what taxpayer alleges is a "non-taxable financing transaction."

STATEMENT OF FACTS

Taxpayer is a subsidiary of an out-of-state holding company (Parent). Taxpayer and 17 affiliates (Subsidiaries) filed a combined return based on the unitary business concept. Only two of the Subsidiaries had nexus with Indiana for purposes of assessing Indiana gross and adjusted gross income tax. All 18 Subsidiaries manage restaurants; there are approximately 50 restaurants in Indiana. Taxpayer had previously requested permission from the Department to file a combined return; pursuant to a phone conversation with a Department of Revenue staff member recommending combined filing "pending approval," taxpayer filed combined returns during the tax year in question. During the audit, an issue arose as to whether or not the Department had granted the required statutory permission in writing. The auditor determined written permission had not been granted, and made adjustments to taxpayer's adjusted gross income tax liability based on the apportionment formula instead of the combined filing method.

A second issue also arose during the audit concerning the characterization of a sale/leaseback transaction as subject to Indiana's gross income tax. Taxpayer asserted in its protest letter that the transaction at issue was a "non-taxable financing arrangement." The audit assessed gross income tax on the sale/leaseback transaction and imposed the 10% negligence penalty. Additional facts will be added as necessary.

I. Corporate Adjusted Gross Income Tax—Combined Filing

DISCUSSION

Taxpayer protests the Audit Division's disallowance of taxpayer's combined filing for 18 affiliated companies for the 1995-1996 tax year. According to taxpayer, the Department recommended that taxpayer file a combined return "pending approval," and then failed to act on taxpayer's request "in a timely manner." Taxpayer now argues that the Department "cannot and should not revoke retroactively its permission allowing [taxpayer] to file a combined return." At the outset, it should be noted that under IC § 6-8.1-5-1(b), a "notice of proposed assessment is *prima facie* evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made."

The procedure governing combined returns is found at IC § 6-3-2-2(q), which states that "one (1) or more taxpayers may petition the department under subsection (l) for permission to file a combined income tax return for a taxable year." (Emphasis added). Subsection (l) sets forth the standards for filing a combined return:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> (1) separate accounting;

> (2) the exclusion of any one (1) or more of the factors;
> (3) the inclusion of one (1) or more additional factors which will fairly represent the taxpayer's income derived from sources within the state of Indiana; or
> (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income. (Emphasis added).

Subsection (p) circumscribes somewhat the Department's authority to require a taxpayer to file a combined return:

> Notwithstanding subsections (l) and (m), the department may not require that income, deductions, and credits attributable to a taxpayer and another entity . . . be reported in a combined income tax return for any taxable year, unless the department is unable to fairly reflect the taxpayer's adjusted gross income for the taxable year through use of other powers granted to the department by subsections (l) and (m). (Emphasis added).

The recurring theme here is the Indiana Legislature's concern with fairly representing a "taxpayer's income derived from sources within the state of Indiana." (IC § 6-3-2-2[l]). Consequently, the Department must exercise a certain degree of care in determining which method fairly represents a corporate taxpayer's liability under Indiana's Adjusted Gross Income Tax statutes and regulations. Since the granting of permission to file a combined return is discretionary with the Department, at any time a combined filing does not fairly represent a taxpayer's Indiana income, then IC § 6-3-2-2(b)'s apportionment formula applies. The Department finds that the requisite statutory permission to file a combined return was not granted to taxpayer. As the phrase "pending approval" implies in the Department's conversations with taxpayer, a reasonable taxpayer would have ascertained whether permission had in fact been granted.

The audit determined taxpayer's combined filing did not fairly represent "taxpayer's income derived from sources within the state of Indiana" for the tax year at issue. (IC § 6-3-2-2[l]). The real issue then becomes whether the Audit Division erred in determining that taxpayer's combined filing status should be disallowed on the basis that the combined return inaccurately reported taxpayer's Indiana income. There are 2 questions to be answered: (1) whether a unitary relationship actually existed between taxpayer and the other 17 Subsidiaries; (2) whether filing a combined return was the only way to fairly represent taxpayer's Indiana income.

The Supreme Court over the years has developed a three-part test in determining whether a unitary relationship exists: common ownership, common management, and common use or operation. *See, e.g., Mobil Oil Corporation v. Commissioner of Taxes of Vermont,* 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin,* 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission,* 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico,* 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation,* 504 U.S. 768, 112 S.

Ct. 2251 (1992). The first item to be considered under this three-part test is common ownership. As a general rule, at least 50% of a corporation's stock must be commonly owned (either directly or indirectly) in order for a corporation to be considered part of a unitary business. The Parent corporation owns a minimum of 80% of its Subsidiaries' stock. The auditor found that the Parent "has ownership of a majority of the voting stock of all other companies included in the returns," including taxpayer. Therefore, taxpayer has established common ownership.

The second criteria to be considered is common management. Common management is shown when a parent corporation provides a management role that is grounded in the parent's own operation expertise and overall operational strategy. *See, e.g., Container Corp. v. Franchise Tax Board,* 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983). The Parent also owns a management company (Management Company) which is "primarily responsible for supporting field operations through centralized management, accounting, advertising, product development, site selection and development," etc. The Parent's Board of Directors is also the Board of Directors for all of the Subsidiaries; each Subsidiary is dependent on the Parent for overall decision-making and strategic planning and direction. The auditor determined that the "group utilizes central decision-making in merchandise selection, advertising, accounting, purchasing, warehousing, training and financing. Centralized management is in evidence, including interlocking directorates and extensive communication between the parent and subsidiaries at high management levels." Therefore, taxpayer has established common management.

The third test is that of common operation or use. Evidence of a common operation exists where certain functions are performed for the group by the parent (such as purchasing, financing, advertising, marketing, research, tax compliance, insurance, and pension plan management) which independent companies would perform for themselves. The Parent negotiates purchasing, insurance, advertising, and similar contracts on a company-wide versus individual company basis. The auditor determined that "economies of scale are utilized between members of the group regarding various expenses. The separate corporations operate effectively as geographic divisions of one business, and the auditor is in agreement that the Taxpayer's unitary reporting fairly represents its activities." (Emphasis added). Therefore, taxpayer has established common use or operation.

The auditor, despite the foregoing evidence and analysis, asserted that "this does not more fairly reflect the Taxpayer's Indiana income than separate reporting," and therefore disallowed the combined filing, based solely on the permission issue discussed *supra*, and on an insufficient flow of product, not services, between companies to justify the filing of a unitary return.

But the analysis does not stop at this point. The question now becomes whether requiring taxpayer to use a standard apportionment or separate company filing method, instead of a combined filing, would result in a failure to fairly reflect the income taxpayer reported as Indiana sources income. The answer to this question turns on whether, under all the circumstances of the unitary relationship between the Parent, taxpayer, and the other Subsidiaries, standard apportionment fulfills the statutory purpose of avoiding distortion of, and realistically portraying, Indiana source income pursuant to IC § 6-3-2-2(p).

It is clear from the language in subsection (l) that the preferred method of filing returns is the standard apportionment or separate company filing method of representing a taxpayer's income derived from Indiana sources. Other methods of income allocation and apportionment (including the combined reporting method) should only be allowed when those provided for by IC § 6-3-2-2 do not fairly reflect a taxpayer's Indiana income. In short, if the Indiana sources income in the instant case can be fairly represented on the basis of standard apportionment or separate company filing method, then such filing methods should be used.

The foundation of much of taxpayer's argument rests upon its assertions that it is impossible and inequitable to attribute Indiana income to it on a separate accounting basis since, due to the unitary nature of the relationship among the entities, the production and service processes of taxpayer, Parent, the other Subsidiaries, and the Management Company, were so interdependent that taxpayer's Indiana income could not be separately determined. However, despite the finding of a unitary relationship between and among taxpayer, Parent, Subsidiaries, and Management, it does not appear that the operation of the businesses were so integrated to the point where the filing of separate returns would lead to a distortion of income. This is the key inquiry and taxpayer's burden of proof: that the preferred method of filing returns does not fairly represent taxpayer's Indiana source income. Taxpayer has not met this burden of proof.

The Department finds that taxpayer has not met its burden of proof in this case. Not only did taxpayer not have the requisite statutory written permission to file a combined return; taxpayer has not demonstrated that its Indiana source income is not fairly represented by using the preferred method of filing, the apportionment formula set forth in IC § 6-3-2-2(b).

FINDING

Taxpayer's protest concerning the Department's disallowance of combined filing of tax returns is denied. When and if circumstances permit, taxpayer may petition the Department again for written permission to file a combined return.

II. Corporate Gross Income Tax—Sale/Leaseback or Sales of Tangible Personal Property

DISCUSSION

Taxpayer protests the assessment of Indiana's gross income tax on what taxpayer alleges is a "non-taxable financing transaction." Taxpayer purchases, installs, and uses restaurant equipment in restaurants. At some point, taxpayer sells the equipment to another entity which then leases the equipment back to taxpayer. The issue is whether or not the income taxpayer received from the transaction is includable in its Indiana gross income.

For purposes of Indiana's gross income tax, gross income is defined as "all the gross receipts a taxpayer receives . . . from the sale, transfer, or exchange of property, real or personal, tangible or intangible." (IC § 6-2.1-1-2(a)[3]). Indiana imposes the gross income tax "upon the receipt of the taxable gross income derived from activities or businesses or any other sources within Indiana by a taxpayer who is not a resident or a domiciliary of Indiana." (IC § 6-2.1-2-2(a)[2]).

Subsection (b) establishes an "applicable rate of tax . . . determined by the type of transaction from which the taxable gross income is received;" *see*, IC §§ 6-2.1-2-3—6-2.1-2-5.
The transaction at issue falls squarely within the ambit of 45 IAC 1-1-29:

> Gross receipts derived from leasing real or personal property are taxable at the higher rate . . . However, when the leasing agreement is purely a financing device for a sale of tangible personal property and such property is sold in the regular course of business by a retail merchant, receipts from the contract are taxable at the lower rate as selling at retail . . .

Indiana's statutes and regulations do not state that such a transaction is not taxable at all. The only question is which tax rate applies, an issue not addressed in the audit. Taxpayer has provided no evidence to support its argument that the transaction at issue is a "non-taxable financing transaction."

FINDING

Taxpayer's protest concerning the assessment of Indiana gross income tax on an alleged "non-taxable financing transaction" is denied.

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